PD-ABL-763

Hungary (Eastern Europe Regional) Sector Grant Assistance

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ACRONYMS

A.I.D.	U.S. Agency for International Development
A.I.D./Rep	A.I.D. Representative to Hungary
GDP	Gross domestic product
GOH	Government of the Republic of Hungary
IEE	Initial Environmental Examination
IMF	International Monetary Fund
NBH	National Bank of Hungary
NEM	New Economic Mechanism
NPA	Non-project assistance
PAAD	Project Assistance Approval Document
SAL	Structural Adjustment Loan
SPA	State Property Agency
SSA	Social Security Administration
U.S.	United States

I. SUMMARY AND RECOMMENDATIONS

A. Summary

This document requests authorization of $10.0 million in funds appropriated under Assistance for Eastern Europe to be provided as sector support assistance to the Republic of Hungary (GOH). This sector cash grant is being provided to support policy reform within the energy sector consistent with the Structural Adjustment Loan (SAL) recently negotiated between the GOH and the World Bank.

The dollars will be used to reimburse the GOH for eligible imports from the United States--i.e. raw materials, spare parts, and intermediate and capital goods required by the productive sector of Hungary. An amount of local currency made available by the GOH, equal to these dollar funds, will be used to finance activities within the energy sector, agreed by the GOH and A.I.D., to support and reinforce the energy sector reforms being undertaken. Specifically, A.I.D. and the GOH have agreed that the local currencies made available will be programmed for use by the GOH as budgetary support for supplemental payments to low income pensioners and non-pensioners, based on the number of children per family, in an attempt to offset the effects of the SAL pricing reforms instituted in the energy sector.

Authorization to approve the entire $10.0 million is requested. Disbursement is planned in a single tranche based on GOH policy changes in the energy sector described in Sections II. and IV. of this document.

B. Recommendation

That this PAAD be approved, authorizing the $10.0 million program and that obligation of a grant for the entire $10.0 million be authorized in FY 1991 Appropriations Act funds for Eastern Europe under the $75 million subheading for energy activities, to be provided as a sector cash grant.

II. ECONOMIC BACKGROUND

A. BACKGROUND

In 1990 Hungarians elected a liberal government which promised gradual change toward a market economy. But slower adjustment did not allow the country to avoid deepening recession, as the new government struggled with a rigid economic system and foreign debts inherited from the Communists.

Industrial production fell by an estimated 10% and GDP by 5.6%. Employment and output in enterprises with more than 50 employees fell by 10%, with this being partially offset by increased jobs in smaller firms, especially those in the private sector. Inflation rose to 30% for the year, although much of the problem was attributable to one-time price adjustments, cuts in subsidies and tax increases. Wage increases, on the other hand, remained well below price increases, an important indicator that underlying inflation was not allowed to get out of hand.

Performance in the trade sector was very strong in the first half of the year, as the economy shifted from dependence on Soviet-bloc-oriented production and trade, dominated by state-owned firms, to trade with the West, characterized by a rising private sector. Trade performance began to wane in the second half, as increased oil import costs, drought and regional economic disruptions combined to hold the trade surplus to $860 million for the year (although this was nearly 60% higher than the surplus in 1989). The current account deficit shrank from $1.4 billion in 1989 to $80 million in 1990.

Nonetheless, the balance-of-payments situation continued to be precarious because of high levels of hard currency debt (over $20 billion, the highest per capita debt level in Eastern Europe), and increased uncertainty on the part of foreign creditors. By the end of 1990, the stock of foreign currency reserves had fallen to the equivalent of only two months of imports. Although Hungarian officials sought to avoid a rescheduling, foreign debt payments due in 1991 rose to $4.6 billion, 14% higher than the previous year.

B. Economic Reform Program

The Hungarian economy inherited by the new, liberal, Democratic Forum government differed significantly from those of surrounding states. Reform Communists, under the rubric of the New Economic Mechanism (NEM) begun in 1968, had gradually pulled the economy away from rigid central planning. That experiment, undertaken under conditions of adherence to strict Communist political orthodoxy, was guided by the concept of decentralized economic management. But decentralized management without private ownership, and maintenance by the Communists of continuing and pervasive 'indirect' economic controls, turned out to be a prescription for inefficiency and stagnation. The economy began sliding into severe recession in the late 1980's. Yet the NEM had allowed consumption levels that compared favorably with other Soviet bloc states through development of the most advanced market institutions in Eastern Europe.

The new government elected in 1990 began by following in the tradition of gradual reform. By the end of 1990, indirect price controls still remained on 70% of prices listed as "free;" the rest were controlled directly. Bankruptcy laws continued not to be applied against state firms. Controls were placed on currency convertibility for Hungarians wishing to travel abroad. Budgetary slippages, caused partly by unanticipated spending, threatened to derail the IMF standby program in the second half of the year. Still, considerable progress was made. Foreign investment and profits repatriation were liberalized. Between September and November of 1990 alone, 65 public enterprises were transformed into joint-stock companies, the initial step in the privatization process. Participation by foreign firms in joint ventures was significant. Although popular reaction against alleged sweetheart deals slowed the process, the government promulgated an oversight process to serve as a check on privatizations initiated outside of government channels, and allowed "spontaneous" privatizations to proceed.

By the end of the year Hungarians were ready for swifter and more comprehensive reform. A program was put forward for a far-reaching, 3-year reform effort, backed by an IMF extended funding facility. In January of 1991, the forint was again devalued and the share of prices free of controls rose to 90%. Oil import cost increases were passed through to the consumer. The government removed trade and exchange restrictions on all but 10% of imports from hard currency countries, fully exposing to foreign competition an estimated 70% of industrial production. Authorities planned to continue restraining monetary growth and external debt accumulation.

The government aims to reduce state-owned assets to no more than 50% of total assets in the competitive sector by 1993, through an ambitious privatization program that would rely mainly on market means: that is, by auction or direct sale. Privatization of some 10,000 small retail shops and restaurants is to be accomplished by end-1992. Groups of about 20 larger scale enterprises will be divested several times a year through the State Property Agency (SPA), especially those requiring restructuring prior to divestiture. So-called spontaneous privatizations, initiated by enterprise management and workers, in tandem with domestic or foreign investors, will be the flagship of the program. Free transfers of state property, or shares in privatized state property, are contemplated only on a limited scale to local authorities and the social security system. The government also is considering providing bonds to owners whose property was expropriated by the Communists after 1949, bonds that could be exchanged for shares in privatized state enterprises. Compensation of the former owners would be partial.

Reinforcing the privatization program are plans to radically restructure public finances, and in particular, lower the absorption or intermediation of resources through the state budget; intensify economic competition; continue liberalizing prices; restructure or allow to go bankrupt loss-making state enterprises; develop an efficient and competitive financial system; and reform the social security system while providing an adequate social safety net.

C. Energy Efficiency

The legacies of central planning and the closed economic relationship between the Soviet Union and Eastern Europe included glaring energy inefficiency. Very high subsidies on imports of Soviet energy, and the previous regime's bias toward state-directed investment and indirect price controls, combined to yield industrial plants that were both wasteful of energy and highly polluting. The new government has laid out, in the context of its Structural Adjustment Loan (SAL) recently negotiated with the World Bank, a comprehensive program to increase energy efficiency, through implementation of cost-based energy pricing.

In 1990, agreement was reached with the World Bank to raise household energy prices according to an agreed timetable. By the end of the year, household energy prices had been increased substantially. All petroleum prices were liberalized at the beginning of 1991, and importation of petroleum products through private channels was permitted. Household energy prices were raised again in February by 50%. The government committed itself to increase natural gas prices by 50% in 1991. By the first quarter of 1992, the GOH plans to announce the elimination of all remaining state budget subsidies for energy, liberalize coal prices and implement new tariff structures for electricity. Administered prices for energy were to be maintained at levels reflecting economic costs.

III. BRIEF PROGRAM DESCRIPTION

The U.S. government will disburse $10.0 million to the GOH in the form of an Energy Sector Grant. In parallel with the World Bank's SAL, the grant will support reforms in energy pricing and subsidy policy designed to improve energy efficiency in Hungary. The grant will provide foreign exchange in support of the GOH's overall program of systemic reforms, to help the economy move quickly to a market basis, recognizing that those reforms will increase Hungary's foreign exchange gap in the short run.

A. Relationship with the World Bank's SAL

The GOH and the World Bank recently negotiated a SAL of $200 million. Under the terms of the agreement, completion of a package of structural adjustment measures was a condition to release of the first of two tranches. This condition was satisfied before presentation of the SAL to the World Bank Board on June 20, 1991. The World Bank will release the second tranche of the SAL when the GOH completes performance targets related to a second package of structural adjustment measures, most likely in 1992.

Disbursement of A.I.D.'s Energy Sector Grant of $10.0 million to the GOH reinforces this policy adjustment process. The Grant funds will help the GOH to continue its momentum in this policy reform process and provide further incentives for completing difficult reforms. A.I.D. will continue to monitor compliance with the letter and spirit of the SAL performance targets, both overall, and in particular those relating to energy efficiency.

The Energy Sector Grant specifically supports implementation of the following policy reform measures in the World Bank SAL relating to energy pricing and subsidies in Hungary:

SAL POLICY REFORM MEASURES

ACTIONS TAKEN PRIOR TO BOARD PRESENTATION	**PRIOR TO SECOND TRANCHE RELEASE**	**BEYOND SAL**
All petroleum prices liberalized at start of 1991	Announcement to eliminate all remaining state budget subsidies for energy at the latest by the end of the heating season in 1992	Agreement to increase household energy prices to the level of economic costs by 1993
Household electricity prices raised 50% on Feb. 1	Liberalize prices for coal	
Increase natural gas prices by 50%	Implement new tariff structures for electricity	
	Implement new tariff structures for maintaining central govt administered prices for energy at economic cost levels	

B. Local Currency Programming

The reform measures initiated by the GOH will increase the energy cost to every consumer. To minimize the hardship caused to fixed income groups at the lower end of the economic strata, the Parliament of Hungary is in the process of passing Bill No. 2899, providing supplemental assistance to low income groups. In addition, a second Bill, No. 2900, is under discussion in the Parliament that further clarifies the benefit package contained in Bill No. 2899. The assistance to be provided would come from budgeted resources channelled through the Pension Disbursing Office of the Social Services Administration.

As part of the Energy Sector Grant Agreement, the Government of Hungary will make available the equivalent of $10.0 million in local currency (forint) to support a budget allowance that will provide one-time supplemental relief to low income groups for the energy price increases resulting from the recent revisions in the energy rate schedules. The budget allowance is being established in accordance with Bill 2899 that provides for financial support from the regular GOH budget to the above identified target groups. The anticipated level to be budgeted will be 4.5 billion forint with the local currency equivalent of the A.I.D. $10.0 million grant at approximately 760 million forint (based on exchange rate of 76 forint to the US dollar on August 21, 1991) or 15% of the total estimated level of the fund.

The programmed funds will be managed by the Social Security Administration. The beneficiaries will be determined by a needs-tested plan based on established criteria and rates for each category that have already been included in the bill and will be the basis for the payments to be provided. Attachment 1 contains the full text of unofficial informal translations of these Bills (Nos. 2899 and 2900)

IV. IMPLEMENTATION AND DISBURSEMENT PLAN

A. IMPLEMENTATION

The Energy Sector Grant Program for Hungary will support energy policy reforms initiated by the GOH as described in Section III above.

It is anticipated that the Energy Sector Program Agreement will be signed by A.I.D. and the GOH in September, 1991. Considerations on the sectoral focus of the program, use of dollars and local currency, and implementing arrangements have been discussed in detail by the design team with representatives of the GOH, as well as with U.S. Embassy officials in Budapest during March-July, 1991. Attachment 2 is the text of the Beneficiary Assessment and Attachment 3 is the text of the Financial Assessment. Both assessments were performed in accordance with recent guidance on programming and monitoring host country-owned local currency. These assessments describe the local currency implementation process, as further described in Section VII, below.

Following PAAD approval in Washington, a draft Program Agreement will be provided to the A.I.D. Representative for Hungary (A.I.D./Rep), Embassy and GOH for final review and approval. For the purposes of the grant, the GOH will be represented by the Ministry of International Economic Relations or the Ministry of Finance which will coordinate final approval and input from other Ministries.

B. DISBURSEMENT PLAN

The disbursement of the $10.0 million sector grant will be made in a single tranche following satisfactory compliance with the conditionality contained in the grant agreement. In particular, enactment of the legislation establishing the program of supplemental payments to minimize the impact of price increases. For the purposes of disbursement, full compliance with program conditionality will be considered to have taken place at this point. It is anticipated that the $10.0 million disbursement may occur as soon as September, 1991, given the likelihood of passage of the legislation by the Hungarian Parliament.

V. Mechanism of the Reimbursement Process

A. Uses of the Sector Cash Grant

The dollar funds provided under this Energy Sector grant will be used to reimburse the GOH for expenditures for imports of U.S. goods, eligible for A.I.D. financing, which have been financed by GOH foreign exchange resources. Criteria for eligibility of imports is contained in Section C. below.

B. Mechanism for the Cash Disbursement

The following set of procedures will be used for disbursement of funds to the Grantee, to be carried out in collaboration with the National Bank of Hungary (which serves as the Central Bank):

1. Upon joint A.I.D./Grantee confirmation of passage of Bill No. 2899 and Bill No. 2900, the Ministry of Finance will request A.I.D. to undertake the disbursement of the

$10.0 million.

2. Upon receipt of the request, A.I.D. will authorize the disbursement of dollars in the form of cash through an Electronic Funds Transfer effected by the U.S. Treasury to an interest bearing Dollar Separate Account in the Federal Reserve Bank of New York on behalf of the National Bank of Hungary and established for the purpose of receiving these funds. The Grant Agreement will require the NBH to provide assurances that this Dollar Separate Account will preclude the mingling of sector grant dollar funds with other resources. Any interest earned by these funds will be credited to and deposited in this Dollar Separate Account.

3. A.I.D. will approve the release of the dollar funds from the Dollar Separate Account in an amount equal to the value of eligible imports from the U.S. shown in documentation provided to A.I.D. by the NBH from time to time. This documentation may be provided at the same time as the request by the GOH for release of dollars, or at any time thereafter. However, to comply with the quick disbursement intent of the assistance, the NBH will be encouraged to submit this documentation as soon as possible.

4. Upon verification of the documents by A.I.D. or its authorized representative (for example, a certified public accounting firm), A.I.D. will authorize the release of the dollars equivalent to the costs of the imports eligible for reimbursement, from the dollars deposited in the Dollar Separate Account, plus any interest earned, to the general foreign currency accounts of the NBH for replenishment of the foreign exchange reserves.

C. Criteria for Import Credit Reimbursement

The Grant uses documentation of the import of eligible U.S. goods and services to Hungary as a trigger mechanism to control release of funds. Reimbursement under the sector grant program for eligible import transactions will be made from the Dollar Separate Account. The NBH will provide the agreed-on documentation supporting eligible transactions undertaken by any parties in Hungary for a period of one year following signature of the Grant Agreement, unless otherwise agreed in writing by A.I.D., for importation of the proposed eligible products.

Before the release of the dollars, the documentation will be reviewed by A.I.D. or its representative in accordance with the previously approved criteria for eligible import transactions. The imports eligible for "reimbursement credit" include: raw materials, intermediate goods, spare parts, capital goods and technical services from the United States not otherwise financed by the U.S. Government.

The following goods and services are <u>ineligible</u> for reimbursement:

- Commodities financed by A.I.D. under PL-480
- Technical services financed by A.I.D. or any other Agency of the U.S. Government
- Pesticides
- Fertilizer (during February through May)
- Passenger cars
- Firearms, explosives and ammunition
- Rubber compounding chemicals and plasticizers
- Military equipment
- Police equipment
- Weather modification equipment
- Surveillance equipment
- Luxury goods (such as gold, silver, coins/stamps, alcoholic beverages, jewelry, and fine furs)
- Abortion equipment
- Gambling equipment
- Non-durable consumer goods

To obtain reimbursement for eligible imports, the NBH will present A.I.D. with the import transaction documentation totalling at least the dollar funds for which release is being requested, plus evidence of the shipment of the goods, and the completion of the required payment. Upon receipt of this information, A.I.D. will satisfy itself that the documentation contains eligible transactions equal to the requested dollar release, plus estimated interest earned on funds deposited in the Dollar Separate Account for which NBH can be reimbursed. The NBH will retain supporting documentation for a period of three years after disbursement of the sector grant, which will be available to A.I.D. or its representative for the purpose of periodic audit.

The review of the import transactions submitted by the NBH will be performed by A.I.D. or, on its behalf, by a recognized local accounting firm in accordance with the criteria set forth in the Grant Agreement or implementation letters. The review must confirm that:

1. The good or service is not on the ineligible list;

2. The source/origin/nationality of the good or service is the United States;

3. The goods and services are not financed by A.I.D. or any other Agency of the U.S. Government;

4. The NBH has on file the application for and approval of the use of foreign exchange, a copy of the supplier's invoice, and the bill of lading confirming shipment of the goods to Hungary; and

5. The importer has made the required payment for the goods or services.

D. Monitoring of the Dollar Disbursements and Releases

The Dollar Separate Account transactions will be monitored by A.I.D. The NBH will advise A.I.D. of any movement in the account, including interest earned, via telex, FAX, or letter as the circumstances may dictate. Bank statements for the Dollar Separate Account are to be provided directly to A.I.D. at least once a month as long as there are funds remaining in the account. After the funds have been fully released from the Dollar Separate Account, the NBH will provide A.I.D. with a copy of a statement for the transfer. A.I.D. monitoring will ensure that all dollar releases are based on complete documentation as required above.

VI. Technical Assistance and Monitoring

The U.S. government has been intimately involved in helping the new government of Hungary to develop a comprehensive program to upgrade energy efficiency through provision of senior-level technical assistance. A wide portfolio of technical assistance activities in energy efficiency is planned, and funds are available for studies and training to assist the Hungarians to implement the energy price liberalization and subsidy elimination measures contained in the World Bank SAL agreement.

Under the regional Emergency Energy project, approximately $1.6 million in technical assistance is being provided to identify and implement low-cost energy efficiency improvements in light industrial complexes and the major Hungarian refineries. Technical assistance and training is also being financed in international oil procurement and energy pricing issues. Additional technical assistance of approximately $2.5 million in FY 1991 is planned under the Regional Energy Efficiency project. These funds will support reform of the power system, improvement in safety and environmental controls in both nuclear and fossil fuel plants, and joint ventures in the provision of efficient energy services. A.I.D. has also offered to provide technical assistance to help the Hungarians to implement their energy sector policy and regulatory reforms.

VII. LOCAL CURRENCY COMPONENT

A. USAGE OF LOCAL CURRENCY

In order to support and reinforce energy policy reform in Hungary, the GOH and A.I.D. have agreed that an amount of local currency equivalent to the program dollars will be made available by the GOH to support energy related activities in Hungary.

Specifically, the local currency "generated" by the grant is to be used to partially offset the increases in living costs imposed on individuals and households as a result of bringing energy prices more closely in line with world prices and the real economic cost of production.

One of the immediate effects of the already initiated and to be enacted energy rate increases undertaken by the GOH is the excessive burden placed on the finances of low income pensioners and non-pensioner families with more than one child. Recognizing this eventuality, the Parliament of Hungary is considering Bill No. 2899 and Bill No. 2900 establishing a fund to provide relief from increased energy costs to low income pensioners (those who receive less than 7,000 forint of retirement, disability and accidental disability, agriculture-cooperative pensions, and augmented trade union allowance) and families receiving allowances for raising children. The fund created under this Bill was based on the recommendation of the Interest Reconciliation Board (a special forum represented by labor, government and business) and represents the best approach to meeting a needs-based energy price compensation plan. An analysis of the proposed scheme performed by A.I.D. indicates the energy compensation fund does in fact target the more needy of Hungary's energy using population. Attachment 2, Beneficiary Assessment, contains the full text of the analysis.

The Bill calls for two payments to be made to qualifying recipients. Implementation of this program and maintenance of the accounts for the funds provided by the Bill will be by the Social Services Administration (SSA). The estimated cost of this program is 5.0 billion forint (4.5 billion forint for payments and the remainder for other costs).

The SSA handles the normal pension process. It is organized along functional lines with the headquarters in Budapest and 19 county offices throughout Hungary. The pension enrollment and payment process is computerized with payments made to approved pensioners through the postal banking system. Neither the SSA headquarters nor the county office staff make direct payments. A two part receipt accompanies each pension payment, one part retained by the recipient pensioner and one part returned to the files of the SSA. The SSA has an internal audit/review staff reviewing the operations of the field and headquarters office to ensure compliance with SSA established policies and procedures. As a result of these reviews, reports are prepared and distributed to the particular office with recommendations or findings requiring a response within 30 days of the issue date of the report. It was found that the SSA has sufficient internal control systems to give reasonable assurance that funds put at its disposal for purposes under Bill 2899 will be used for these purposes.

B. LOCAL CURRENCY PLAN

The National Bank of Hungary (NBH) will open and manage a separate interest bearing local currency account for the local currency proceeds of this grant. Within three days after A.I.D. authorizes disbursement of dollar funds for approved expenditures from the separate dollar account, the NBH will deposit the equivalent local currency (forint) into the above mentioned local currency separate account. Upon notification by the NBH to A.I.D. that the deposit has occurred, A.I.D. will notify the NBH that local currency in the local currency separate account may be transferred to the general account earmarked for disbursement by the Pension Distribution Office of the SSA for the payments of benefits authorized under Bill 2899.

It is anticipated that very few transfers from this local currency separate account will be required since the supplemental payments by the SSA to approved recipients is planned to occur only twice. Since the size of this supplemental benefit program is far greater than the local currency to be generated by this grant (4.5 billion forint for the program with the estimated local currency to be generated by the A.I.D. $10.0 million grant at 760 million forint, based on an exchange rate of 76 forint to 1 US$ as of 8/21/91, or less than 15% of the total), transfers from this local currency separate account can be made immediately. Therefore, the number of transfers from the local currency separate account to the NBH general account for this program will in reality not be dependent on the local use, but upon the approved disbursements from the dollar separate account for the grant.

The NBH will maintain records for the local currency separate account in the same manner as for the dollar separate account. The standard NBH practice is to issue monthly statements on transactions (including interest earned) during the reporting period for all types of accounts. The monthly statements for the local currency separate account will be forwarded to A.I.D. to be reviewed for compliance with the terms of this Grant.

As the local currencies in question will be co-mingled with other GOH resources in the NBH general account for the supplemental fund, A.I.D. will not be involved in the tracking or monitoring of these local currency funds, other than notification by the Hungarian authorities that the funds have been transferred from the special local currency account to the general account earmarked for disbursement for benefits authorized under Bill 2899. However, A.I.D. will maintain appropriate audit rights.

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